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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 5, 2004

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file Number: 0-15175

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**ADOBE SYSTEMS INCORPORATED**

(Exact name of registrant as specified in its charter)

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**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**77-0019522**

(I.R.S. Employer Identification No.)

**345 Park Avenue, San Jose, California 95110-2704**

(Address of principal executive offices and zip code)

**(408) 536-6000**

(Registrant's telephone number, including area code)

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Indicate by checkmark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 (the "Act") during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ☒ No ☐

The number of shares outstanding of the registrant's common stock as of April 2, 2004 was 238,738,982.

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**ADOBE SYSTEMS INCORPORATED**  
**FORM 10-Q**

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**PART I—FINANCIAL INFORMATION****ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**ADOBE SYSTEMS INCORPORATED**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands, except per share data)  
(Unaudited)

	March 5, 2004	November 28, 2003
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents . . . . .	\$ 199,759	\$ 189,917
Short-term investments . . . . .	1,049,576	906,616
Trade receivables, net . . . . .	122,955	146,311
Other receivables . . . . .	32,035	27,731
Deferred income taxes . . . . .	27,955	35,875
Other current assets . . . . .	29,858	22,578
Total current assets . . . . .	1,462,138	1,329,028
Property and equipment, net . . . . .	82,512	77,007
Goodwill . . . . .	95,971	95,971
Purchased and other intangibles, net . . . . .	15,161	15,318
Other assets . . . . .	35,724	37,721
Total assets . . . . .	<u>\$ 1,691,506</u>	<u>\$ 1,555,045</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Trade and other payables . . . . .	\$ 35,598	\$ 37,437
Accrued expenses . . . . .	175,508	160,009
Income taxes payable . . . . .	185,363	193,484
Deferred revenue . . . . .	43,326	45,600
Total current liabilities . . . . .	439,795	436,530
Deferred income taxes . . . . .	34,227	17,715
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$0.0001 par value . . . . .	29,576	29,576
Additional paid-in-capital . . . . .	901,831	874,126
Retained earnings . . . . .	1,920,444	1,800,398
Accumulated other comprehensive income (loss) . . . . .	5,582	(999)
Treasury stock, at cost, (57,142 and 57,464 shares in 2004 and 2003, respectively), net of re-issuances . . . . .	(1,639,949)	(1,602,301)
Stockholders' equity . . . . .	1,217,484	1,100,800
Total liabilities and stockholders' equity . . . . .	<u>\$ 1,691,506</u>	<u>\$ 1,555,045</u>

*See accompanying Notes to Condensed Consolidated Financial Statements.*

**ADOBE SYSTEMS INCORPORATED**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
(In thousands, except per share data)  
(Unaudited)

	<b>Three Months Ended</b>	
	<b>March 5, 2004</b>	<b>February 28, 2003</b>
Revenue:		
Products . . . . .	\$415,752	\$290,755
Services and support . . . . .	7,529	6,140
Total revenue . . . . .	<u>423,281</u>	<u>296,895</u>
Cost of revenue:		
Products . . . . .	20,444	19,360
Services and support . . . . .	3,738	3,002
Total cost of revenue . . . . .	<u>24,182</u>	<u>22,362</u>
Gross profit . . . . .	399,099	274,533
Operating expenses:		
Research and development . . . . .	75,071	65,956
Sales and marketing . . . . .	127,354	98,028
General and administrative . . . . .	33,412	30,041
Total operating expenses . . . . .	<u>235,837</u>	<u>194,025</u>
Operating income . . . . .	163,262	80,508
Non-operating income:		
Investment loss . . . . .	(1,031)	(6,692)
Interest and other income . . . . .	4,032	3,649
Total non-operating income (loss) . . . . .	<u>3,001</u>	<u>(3,043)</u>
Income before income taxes . . . . .	166,263	77,465
Provision for income taxes . . . . .	43,228	23,240
Net income . . . . .	<u>\$123,035</u>	<u>\$ 54,225</u>
Basic net income per share . . . . .	<u>\$ 0.52</u>	<u>\$ 0.23</u>
Shares used in computing basic net income per share . . . . .	<u>238,384</u>	<u>231,084</u>
Diluted net income per share . . . . .	<u>\$ 0.50</u>	<u>\$ 0.23</u>
Shares used in computing diluted net income per share . . . . .	<u>246,087</u>	<u>235,294</u>
Cash dividends declared per share . . . . .	<u>0.0125</u>	<u>0.0125</u>

*See accompanying Notes to Condensed Consolidated Financial Statements.*

**ADOBE SYSTEMS INCORPORATED**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)  
(Unaudited)

	<b>Three Months Ended</b>	
	<b>March 5, 2004</b>	<b>February 28, 2003</b>
Cash flows from operating activities:		
Net income	\$ 123,035	\$ 54,225
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	13,438	11,992
Stock-based compensation expense	184	952
Deferred income taxes	23,110	5,744
Provision for (recovery of) losses on receivables	(2,114)	495
Tax benefit from employee stock option plans	5,124	2,014
Net losses on sales and impairments of investments	1,031	6,693
Changes in operating assets and liabilities:		
Receivables	21,166	(12,560)
Other current assets	(4,281)	(2,492)
Trade and other payables	(1,839)	(3,574)
Accrued expenses	17,589	14,410
Accrued restructuring charges	(587)	(4,742)
Income taxes payable	(8,121)	4,891
Deferred revenue	(2,274)	1,299
Net cash provided by operating activities	<u>185,461</u>	<u>79,347</u>
Cash flows from investing activities:		
Purchases of short-term investments	(394,307)	(124,464)
Maturities and sales of short-term investments	255,342	45,568
Purchases of property and equipment	(14,444)	(7,490)
Purchases of long-term investments and other assets	(4,305)	(3,516)
Proceeds from sale of equity securities	—	1,764
Net cash used for investing activities	<u>(157,714)</u>	<u>(88,138)</u>
Cash flows from financing activities:		
Purchases of treasury stock	(55,607)	(45,207)
Proceeds from issuance of treasury stock	40,356	13,729
Payment of dividends	(2,986)	(2,887)
Net cash used for financing activities	<u>(18,237)</u>	<u>(34,365)</u>
Effect of foreign currency exchange rates on cash and cash equivalents	332	1,569
Net increase (decrease) in cash and cash equivalents	9,842	(41,587)
Cash and cash equivalents at beginning of period	189,917	183,684
Cash and cash equivalents at end of period	<u>\$ 199,759</u>	<u>\$ 142,097</u>
Supplemental disclosures:		
Cash paid during the period for income taxes	<u>\$ 21,231</u>	<u>\$ 8,766</u>
Non-cash investing and financing activities:		
Cash dividends declared but not paid	<u>\$ 2,983</u>	<u>\$ 2,891</u>
Unrealized gains on available-for-sale securities, net of taxes	<u>\$ 3,025</u>	<u>\$ 1,066</u>

*See accompanying Notes to Condensed Consolidated Financial Statements.*

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(In thousands, except share and per share data)**  
**(Unaudited)**

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Basis of Presentation*

The accompanying condensed consolidated financial statements include those of Adobe and our subsidiaries, after elimination of all intercompany accounts and transactions. Adobe has prepared the accompanying interim condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, consistent in all material respects with those applied in our Annual Report on Form 10-K for the year ended November 28, 2003. The interim financial information is unaudited but reflects all adjustments which are, in the opinion of management, necessary to provide fair condensed consolidated balance sheets, condensed consolidated statements of income and cash flows for the interim periods presented. Such adjustments are normal and recurring except as otherwise noted. You should read these interim condensed consolidated financial statements in conjunction with the audited financial statements in our Annual Report on Form 10-K for the year ended November 28, 2003.

*Revenue Recognition*

Our revenue is derived from the licensing of software and server-based products, professional services, and maintenance and support. We recognize revenue when persuasive evidence of an arrangement exists, we have delivered the product or performed the service, the fee is fixed or determinable and collection is probable.

*Product revenue*

We recognize our product revenue upon shipment, provided collection is determined to be probable and no significant obligations remain on our part. Our desktop application products revenue from distributors is subject to agreements allowing limited rights of return, rebates, and price protection. Accordingly we reduce revenue recognized for estimated future returns, price protection and rebates at the time the related revenue is recorded. The estimates for returns are adjusted periodically based upon historical rates of returns, inventory levels in the distribution channel and other related factors.

We provide free technical phone support to customers for our shrink-wrapped application products under warranty. We record the estimated cost of free technical phone support upon shipment of software.

We record OEM licensing revenue, primarily royalties, when OEM partners ship products incorporating Adobe software, provided collection of such revenue is deemed probable.

Our product-related deferred revenue includes customer advances under OEM license agreements and maintenance upgrade revenue. Our maintenance upgrade revenue for our desktop application products is included in our product revenue line item as the maintenance primarily entitle customers to receive product upgrades. In cases, where we provide a specified free upgrade to an existing product, we defer the fair value for the specified upgrade right, until the future obligation is fulfilled or when the right to the specified free upgrade expires.

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(In thousands, except share and per share data)**  
**(Unaudited)**

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

*Services and support revenue*

Our services and support revenue is composed of professional services (such as consulting services and training) and maintenance and support, primarily related to the licensing of our Intelligent Documents server solution products. Our support revenue also includes technical support and developer support to partners and developer organizations related to our desktop products.

Our professional services revenue is recognized using the percentage of completion method and is measured monthly based on input measures, such as on hours incurred to date compared to total estimated hours to complete, with consideration given to output measures, such as contract milestones, when applicable. Our maintenance and support offerings, which entitles customers to receive product upgrades and enhancements or technical support, depending on the offering, is recognized ratably over the term of the arrangement.

*Multiple element arrangements*

We enter into revenue arrangements in which a customer may purchase a combination of software, upgrades, maintenance and support, and professional services (multiple-element arrangements). When vendor-specific objective evidence ("VSOE") of fair value exists for all elements, we allocate revenue to each element based on the relative fair value of each of the elements. VSOE of fair value is established by the price charged when that element is sold separately. For maintenance and support, VSOE of fair value is established by renewal rates. For arrangements where VSOE exists only for the undelivered elements, we defer the full fair value of the undelivered elements and recognize the difference between the total arrangement fee and the amount deferred for the undelivered items as revenue, assuming all other criteria for revenue recognition have been met.

We perform ongoing credit evaluations of our customers' financial condition and in some cases we require various forms of security. We also maintain allowances for estimated credit losses.

*Stock-Based Incentive Compensation*

We account for our fixed stock option plans and our employee stock purchase plan using the intrinsic value method under Accounting Principles Board Opinion No. 25. The following table sets forth the pro forma amounts of net income and net income per share, for the three months ended March 5, 2004 and February 28, 2003, that would have resulted if we had accounted for our employee stock plans under the

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
(In thousands, except share and per share data)  
(Unaudited)

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

fair value recognition provisions of Statement of Financial Accounting Standards No. 123 ("SFAS 123"), "Accounting for Stock-Based Compensation."

	<u>2004</u>	<u>2003</u>
Net income (loss):		
As reported . . . . .	\$123,035	\$ 54,225
Add: Stock-based compensation expense for employees included in reported net income, net of related tax effects . . . . .	120	619
Less: Total stock-based compensation expense for employees determined under the fair value based method, net of related tax effects . . . . .	<u>(27,894)</u>	<u>(58,466)</u>
Pro forma . . . . .	<u>\$ 95,261</u>	<u>\$ (3,622)</u>
Basic net income (loss) per share:		
As reported . . . . .	\$ 0.52	\$ 0.23
Pro forma . . . . .	\$ 0.40	\$ (0.02)
Diluted net income (loss) per share:		
As reported . . . . .	\$ 0.50	\$ 0.23
Pro forma . . . . .	\$ 0.39	\$ (0.02)

For purposes of computing pro forma net income (loss), we estimate the fair value of each option grant and employee stock purchase plan purchase right on the date of grant using the Black-Scholes option pricing model. The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable, characteristics not present in our option grants and employee stock purchase plan shares. Additionally, option valuation models require the input of highly subjective assumptions, including the expected volatility of the stock price. Because our employee stock options and employee stock purchase plan shares have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimates, in management's opinion, the existing models do not provide a reliable single measure of the fair value of its stock-based awards.

The assumptions used to value the option grants and purchase rights, for the quarters ended March 5, 2004 and February 28, 2003, are as follows:

	<u>2004</u>	<u>2003</u>
Expected life of options (in years) . . . . .	2.5	3
Expected life of purchase rights (in years) . . . . .	1.24	1.24
Volatility . . . . .	40%	69%
Risk free interest rate—options . . . . .	2.18% - 2.44%	2.14 - 4.14%
Risk free interest rate—purchase rights . . . . .	1.24% - 1.76%	1.96 - 3.03%
Dividend yield . . . . .	0.125%	0.125%



**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
(In thousands, except share and per share data)  
(Unaudited)

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Options and restricted stock grants vest over several years, and new option and restricted stock grants are generally made each year. Because of this, the pro forma amounts shown above may not be representative of the pro forma effect on reported net income in future years.

*Income Taxes*

We use the asset and liability method of accounting for income taxes. Under the asset and liability method, we recognize deferred tax assets and liabilities for the future tax consequences attributable to differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities. We record a valuation allowance to reduce deferred tax assets to an amount for which realization is more likely than not. We also account for any income tax contingencies in accordance with Statement of Financial Accounting Standards No. 5 ("SFAS 5"), "Accounting for Contingencies."

*Recent Accounting Pronouncements*

In December 2003, the FASB issued Interpretation No. 46R ("FIN 46R"), a revision to FIN 46. FIN 46R clarifies some of the provisions of FIN 46 and exempts certain entities from its requirements. FIN 46R is effective at the end of the first interim period ending after December 15, 2003. We have considered the provisions of FIN 46R and believe it will not be necessary to include in our financial statements any assets, liabilities, or activities of the third-party entities holding our corporate headquarters leases. We have provided certain disclosures related to these leases in other areas of this Quarterly Report on Form 10-Q (see Note 7 of our Notes to Condensed Consolidated Financial Statements). Under the provisions of FIN 46R, we began consolidating our Adobe Ventures partnerships in the first quarter of fiscal 2004. This consolidation did not have a material impact on our consolidated financial position, results of operations or cash flows.

In December 2003, the SEC issued Staff Accounting Bulletin No. 104 ("SAB 104"), "Revenue Recognition", which supercedes Staff Accounting Bulletin No. 101 ("SAB 101"), "Revenue Recognition in Financial Statements." The primary purpose of SAB 104 is to rescind accounting guidance contained in SAB 101 related to multiple element revenue arrangements, which was superceded as a result of the issuance of Emerging Issues Task Force 00-21 ("EITF 00-21"), "Accounting for Revenue Arrangements with Multiple Deliverables." SAB 104 also incorporated certain sections of the SEC's "Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers" document. While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104. The adoption of SAB 104 did not have a material impact on our consolidated financial position, results of operations or cash flows.

**NOTE 2. GOODWILL AND PURCHASED AND OTHER INTANGIBLES**

Below is a breakdown of our goodwill, net of amortization, reported by segment as of March 5, 2004:

	Digital Imaging and Video	Creative Professional	Intelligent Documents*	Total
Goodwill, net of amortization . . . . .	\$14,112	\$4,650	\$77,209	\$95,971

\* Formerly named ePaper.

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
(In thousands, except share and per share data)  
(Unaudited)

**NOTE 2. GOODWILL AND PURCHASED AND OTHER INTANGIBLES (Continued)**

In accordance with Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," we review our goodwill periodically for impairment.

Identifiable intangible assets, subject to amortization, were as follows as of March 5, 2004:

	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Net</u>
Purchased technology . . . . .	\$28,549	\$(20,894)	\$ 7,655
Localization . . . . .	12,157	(5,045)	7,112
Trademarks . . . . .	300	(106)	194
Other intangibles . . . . .	682	(482)	200
Total other intangible assets . . . . .	13,139	(5,633)	7,506
Total purchased and other intangible assets . . . . .	<u>\$41,688</u>	<u>\$(26,527)</u>	<u>\$15,161</u>

Identifiable intangible assets subject to amortization were as follows as of November 28, 2003:

	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Net</u>
Purchased technology . . . . .	\$28,509	\$(18,875)	\$ 9,634
Localization . . . . .	\$10,540	\$ (5,348)	\$ 5,192
Trademarks . . . . .	300	(97)	203
Other intangibles . . . . .	716	(427)	289
Total other intangible assets . . . . .	\$11,556	\$ (5,872)	\$ 5,684
Total purchased and other intangible assets . . . . .	<u>\$40,065</u>	<u>\$(24,747)</u>	<u>\$15,318</u>

Amortization expense related to purchased and other intangible assets was \$4.5 million and \$3.6 million in the first quarter of fiscal 2004 and 2003, respectively. As of March 5, 2004, we expect amortization expense in future periods to be as shown below:

<u>Fiscal year</u>	<u>Purchased Technology</u>	<u>Other Intangible Assets</u>
Remainder of 2004 . . . . .	\$3,894	\$6,435
2005 . . . . .	3,214	927
2006 . . . . .	547	18
2007 . . . . .	—	18
2008 . . . . .	—	18
2009 . . . . .	—	18
Thereafter . . . . .	—	72
Total expected amortization expense . . . . .	<u>\$7,655</u>	<u>\$7,506</u>

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
(In thousands, except share and per share data)  
(Unaudited)

**NOTE 3. OTHER ASSETS**

Other assets consisted of the following as of March 5, 2004 and November 28, 2003:

	<u>2004</u>	<u>2003</u>
Investments . . . . .	\$28,971	\$30,840
Security deposits and other . . . . .	3,384	3,503
Land deposit . . . . .	3,369	3,378
Total other assets . . . . .	<u>\$35,724</u>	<u>\$37,721</u>

We own limited partnership interests in Adobe Ventures which are consolidated in accordance with FIN 46R. The partnerships are controlled by Granite Ventures, an independent venture capital firm and sole general partner of Adobe Ventures. As of March 5, 2004 and November 28, 2003, the estimated fair value of our investments in Adobe Ventures were \$31.5 million and \$30.6 million, respectively.

We recognize realized gains and losses upon the sale of investments using the specific identification method. During the first quarter of fiscal 2004 and 2003, we recorded investment losses of \$1.0 million and \$6.7 million, respectively, which comprise gains and losses from our short-term and long-term investments. Of these losses, \$1.2 million and \$3.6 million, respectively, related to our investments in Adobe Ventures and our cost method investments. During the first quarter of fiscal 2004, these losses were partially offset by gains on short-term investments of \$0.2 million. During the first quarter of 2003, investment losses also included write-downs due to other-than-temporary declines in value, of \$3.9 million, related to our short-term investments. The losses for the first quarter of fiscal 2003 were partially offset by gains of \$0.8 million, from the sale of marketable equity securities.

**NOTE 4. ACCRUED EXPENSES**

Accrued expenses consisted of the following as of March 5, 2004 and November 28, 2003:

	<u>2004</u>	<u>2003</u>
Accrued compensation and benefits . . . . .	\$ 74,721	\$ 65,870
Sales and marketing allowances . . . . .	14,533	14,169
Accrued restructuring . . . . .	545	1,132
Other . . . . .	85,709	78,838
Total accrued expenses . . . . .	<u>\$175,508</u>	<u>\$160,009</u>

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
(In thousands, except share and per share data)  
(Unaudited)

**NOTE 5. RESTRUCTURING AND OTHER CHARGES**

In connection with our acquisition of Accelio in the second quarter of fiscal 2002, we recognized \$14.5 million in liabilities associated with a worldwide reduction in force of Accelio employees, transaction costs, costs related to closing redundant facilities and terminating contracts and other exit costs associated with the acquisition. As of March 5, 2004, \$0.5 million remained accrued and comprised transaction, facilities and other exit costs. Transaction costs primarily relate to the liquidation of Accelio's subsidiaries and are expected to be paid through fiscal 2004. Facility costs relate to leases we assumed upon acquisition of Accelio and terminate through September 2006. Other exit costs relate to specifically identified contingent liabilities which will be paid through fiscal 2004.

A summary of restructuring activities, related to our acquisition of Accelio, is as follows:

	Balance at November 28, 2003	Cash Payments	Balance at March 5, 2004
Transaction costs . . . . .	\$ 255	\$ (35)	\$220
Cost of closing redundant facilities . . . . .	829	(546)	283
Other exit costs . . . . .	48	(6)	42
Total . . . . .	<u>\$1,132</u>	<u>\$(587)</u>	<u>\$545</u>

**NOTE 6. STOCKHOLDERS' EQUITY**

*Stock Repurchase Program I—On-going Dilution Coverage*

To facilitate our stock repurchase program designed to minimize dilution from stock issuance primarily from employee stock plans, we have repurchased shares in the open market, sold put warrants and purchased call options.

Authorization to repurchase shares to cover on-going dilution is not subject to expiration. However, this repurchase program is limited to covering net dilution from stock issuances and is subject to business conditions and cash flow requirements as determined by our Board of Directors from time to time. In the first quarter of fiscal 2004, we repurchased approximately 1.4 million shares in the open market at an average price of \$38.78 and employees surrendered 3,886 shares in lieu of cash payments for the option exercise price or withholding taxes due. During the first quarter of fiscal 2003 we repurchased approximately 1.6 million shares through the exercise of outstanding put warrants at an average price of \$28.47 and employees surrendered 3,445 shares in lieu of cash payments for withholding taxes due. The cost of repurchases in the first quarter of fiscal 2004 and 2003 was \$55.6 million and \$45.2 million, respectively. As of March 5, 2004, 21.9 million shares remained authorized for repurchase, based on net stock issuances less repurchases under this plan.

*Stock Repurchase Program II—Additional Authorization above Dilution Coverage*

On September 25, 2002, our Board of Directors authorized a program to purchase up to an additional 5.0 million shares of our common stock over a three-year period, subject to certain business and cash flow

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(In thousands, except share and per share data)**  
**(Unaudited)**

**NOTE 6. STOCKHOLDERS' EQUITY (Continued)**

requirements. We have not made any purchases under this 5.0 million share repurchase program. The authorization for this program will expire in September 2005.

**NOTE 7. COMMITMENTS AND CONTINGENCIES**

*Lease Commitments*

We lease certain of our facilities and some of our equipment under noncancelable operating lease arrangements that expire at various dates through 2091.

In December 2003, upon completion of construction, we began a five year lease agreement of a new office building for our corporate headquarters in San Jose, California. Under the agreement, we have the option to purchase the building at any time during the term for an amount equal to the lease balance which is approximately \$103.0 million. The maximum recourse amount ("residual value guarantee"), under this obligation, is \$90.8 million.

In August 1999, we entered into a five-year lease agreement for our other two office buildings that currently serve as our corporate headquarters in San Jose, California. Under the agreement, we have the option to purchase the buildings at any time during the lease term for the lease balance, which is approximately \$142.5 million. The maximum recourse amount ("residual value guarantee"), under this obligation, is \$132.6 million. This agreement expires in August 2004 and we are in the process of evaluating alternative financing. We believe that several suitable financing options will be available to us.

These two leases are both subject to standard covenants including liquidity, leverage and profitability ratios that are reported to the lessor quarterly. As of March 5, 2004, we were in compliance with all covenants. In the case of a default, the lessor may demand we purchase the buildings for an amount equal to the lease balance, or require that we remarket or relinquish the buildings. The agreements qualify for operating lease accounting treatment under SFAS 13 and, as such, the buildings and the related obligations are not included on our balance sheet. We utilized this type of financing in order to access bank-provided funding at the most favorable rates and allows us to maintain our cash balances for other corporate purposes. At the end of the lease term, we can purchase the buildings for the lease balance, remarket or relinquish the buildings. If we choose to remarket or are required to do so upon relinquishing the buildings, we are bound to arrange the sale of the buildings to an unrelated party and will be required to pay the lessor any shortfall between the net remarketing proceeds and the lease balance, up to the maximum recourse amount.

*Royalties*

We have certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a dollar amount per unit shipped or a percentage of the underlying revenue.

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
(In thousands, except share and per share data)  
(Unaudited)

**NOTE 7. COMMITMENTS AND CONTINGENCIES (Continued)**

*Guarantees*

The lease agreements for our three office buildings in San Jose, California provide for residual value guarantees. These lease agreements were in place prior to December 31, 2002 and are therefore not required to be recorded on our balance sheet but are disclosed above under "Lease Commitments".

In the normal course of business, we provide indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our products. Historically, costs related to these indemnification provisions have not been significant and we are unable to estimate the maximum potential impact of these indemnification provisions on our future results of operations.

We have commitments to make certain milestone and/or retention payments typically entered into in conjunction with various acquisitions, for which we have made accruals in our consolidated financial statements. In connection with our purchases of technology assets during fiscal 2003, we entered into employee retention agreements totaling \$2.2 million. We are required to make payments upon satisfaction of certain conditions in the agreements.

As permitted under Delaware law, we have agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have director and officer insurance coverage that limits our exposure and enables us to recover a portion of any future amounts paid. We believe the estimated fair value of these indemnification agreements in excess of applicable insurance coverage is minimal.

As part of our limited partnership interests in Adobe Ventures, we have provided a general indemnification to Granite Ventures, an independent venture capital firm and sole general partner of Adobe Ventures, for certain events or occurrences while Granite Ventures is, or was serving, at our request in such capacity provided that Granite Ventures acts in good faith on behalf of the partnerships. We are unable to develop an estimate of the maximum potential amount of future payments that could potentially result from any hypothetical future claim, but believe the risk of having to make any payments under this general indemnification to be remote.

We accrue for costs associated with future obligations which include costs for undetected bugs that are discovered only after the product is installed and used by customers. The accrual remaining as of March 5, 2004 primarily relates to InDesign and Version Cue. The table below summarizes the activity related to the accrual for the quarter ended March 5, 2004:

Balance at November 28, 2003	Accruals	Payments	Balance at March 5, 2004
\$ 3,185	\$ —	\$ (2,690)	\$ 495

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(In thousands, except share and per share data)**  
**(Unaudited)**

**NOTE 7. COMMITMENTS AND CONTINGENCIES (Continued)**

*Legal Actions*

In early 2002, International Typeface Corporation (“ITC”) and Agfa Monotype Corporation (“AMT”), companies which have common ownership and management, each charged, by way of informal letters to Adobe, that Adobe’s distribution of font software, which generates ITC and AMT typefaces, breaches its contracts with ITC and AMT, respectively, pursuant to which Adobe licensed certain rights with respect to ITC and AMT typefaces. AMT and ITC further charged that Adobe violated the Digital Millennium Copyright Act (“DMCA”) with respect to, or induced or contributed to, the infringement of copyrights in, ITC’s and AMT’s TrueType font software.

On September 4, 2002, Adobe initiated arbitration proceedings in London, England (“the London Arbitration”) against AMT, seeking a declaration that Adobe’s distribution of font software that generates AMT typefaces did not breach its contract pursuant to which it licensed certain rights with respect to AMT typefaces. AMT has made a breach of contract claim in response to Adobe’s arbitration demand in the London Arbitration, asserting that Adobe wrongfully granted and/or allowed third parties greater rights to distribute and embed AMT fonts than Adobe was licensed to grant and/or allow.

Adobe asserts that it negotiated for and obtained express, written licenses from both AMT and ITC approximately ten years ago permitting Adobe to allow end users to embed AMT and ITC fonts in electronic documents for “print and view” and disputes the other breach of contract claims. Adobe also asserts that Adobe Acrobat 5.0, which AMT and ITC correctly acknowledge has been superseded by subsequent versions, neither violates the DMCA nor induces or contributes to the infringement of copyrights in ITC’s and AMT’s TrueType font software.

On September 5, 2002, AMT and ITC filed suit against Adobe in the U.S. District Court, Eastern District of Illinois (“the Illinois Action”), asserting only that Adobe’s distribution of the superseded 5.0 version of Adobe Acrobat violated the DMCA, as described above. The Illinois Action seeks statutory damages of \$200 to \$2,500 for each copy of Acrobat 5.0 found to violate the DMCA, a claim that Adobe disputes as a matter of law and fact. The Illinois Action also seeks injunctive relief with respect to Acrobat 5.0, although it specifically alleges, correctly, that Adobe no longer distributes Acrobat 5.0.

On November 13, 2002, ITC filed another suit against Adobe in the United States District Court for the Eastern District of Illinois, this time asserting that Adobe breached its contract with ITC and that ITC, not Adobe, owns the copyrights in font software created by Adobe which generates ITC typefaces.

If either AMT or ITC prevails on its breach of contract claims, AMT or ITC may have the right to terminate Adobe’s right to distribute any of its products that then still contain font software that generates AMT or ITC typefaces.

The results of any litigation are inherently uncertain and Adobe cannot assure that it will be able to successfully defend itself against any of the actions described above. AMT and ITC seek an unspecified aggregate dollar amount of damages. A favorable outcome for AMT or ITC in these actions could have a material adverse effect on Adobe’s financial position, cash flows or results of operations. We believe that all of AMT’s and ITC’s claims are without merit and we are vigorously defending against them in addition to pursuing our own claims as described above. We cannot estimate any possible loss at this time.

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(In thousands, except share and per share data)**  
**(Unaudited)**

**NOTE 7. COMMITMENTS AND CONTINGENCIES (Continued)**

On September 6, 2002, Plaintiff Fred B. Dufresne filed suit against Adobe, Microsoft Corporation, Macromedia, Inc. and Trellox Corporation in the U.S. District Court, District of Massachusetts, alleging infringement of U.S. Patent No. 5,835,712, entitled “Client-Server System Using Embedded Hypertext Tags for Application and Database Development.” The Plaintiff’s complaint asserts that “Defendants have infringed, and continue to infringe, one or more claims of the “712 patent by making, using, selling and/or offering for sale, *inter alia*, products supporting Microsoft Active Server Pages technology.” The plaintiff seeks unspecified compensatory damages, preliminary and permanent injunctive relief, trebling of damages for “willful infringement,” and fees and costs. We believe the action has no merit and are vigorously defending against it. We cannot estimate any possible loss at this time.

On November 18, 2002, Plaintiffs Shell & Slate Software Corporation and Ben Weiss filed a civil action in the U.S. District Court in Los Angeles against Adobe alleging false designation of origin, trade secret misappropriation, breach of contract and other causes of action. The claim derives from the Plaintiffs’ belief that the “healing brush” technique of Adobe Photoshop software incorporates the Plaintiffs’ trade secrets. The Plaintiffs seek preliminary and permanent injunctive relief, compensatory, treble and punitive damages and fees and costs. We believe the action has no merit and are vigorously defending against it. On September 9, 2003, Adobe filed a counter-claim against Ben Weiss for breach of contract and misappropriation of trade secrets. Adobe seeks compensatory, statutory and punitive damages. We cannot estimate any possible loss at this time.

From time to time, Adobe is subject to legal proceedings, claims, investigations and proceedings in the ordinary course of business, including claims of alleged infringement of third-party patents and other intellectual property rights, commercial, employment and other matters. In accordance with SFAS 5, “Accounting for Contingencies,” Adobe makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. Litigation is inherently unpredictable. However, Adobe believes that it has valid defenses with respect to the legal matters pending against it. It is possible, nevertheless, that our financial position, cash flows or results of operations could be affected in any particular period by the resolution of one or more of these contingencies.

**NOTE 8. FINANCIAL INSTRUMENTS**

In accordance with Statement of Financial Accounting Standards No. 133 (“SFAS 133”), “Accounting for Derivative Instruments and Hedging Activities” we recognize derivative instruments and hedging activities as either assets or liabilities on the balance sheet and measure them at fair value. Gains and losses resulting from changes in fair value are accounted for depending on the use of the derivative and whether it is designated and qualifies for hedge accounting.

*Economic Hedging—Hedges of Forecasted Transactions*

We use option and forward foreign exchange contracts to hedge certain operational (“cash flow”) exposures resulting from changes in foreign currency exchange rates. These foreign exchange contracts, carried at fair value, may have maturities between one and twelve months. Such cash flow exposures result



**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
(In thousands, except share and per share data)  
(Unaudited)

**NOTE 8. FINANCIAL INSTRUMENTS (Continued)**

from portions of our forecasted revenues denominated in currencies other than the U.S. dollar, primarily the Japanese yen and the euro. We enter into these foreign exchange contracts to hedge forecasted product licensing revenue in the normal course of business, and accordingly, they are not speculative in nature.

We record changes in the intrinsic value of these cash flow hedges in accumulated other comprehensive income (loss), until the forecasted transaction occurs. When the forecasted transaction occurs, we reclassify the related gain or loss on the cash flow hedge to revenue. In the event the underlying forecasted transaction does not occur, or it becomes probable that it will not occur, we reclassify the gain or loss on the related cash flow hedge from accumulated other comprehensive income (loss) to interest and other income (loss) on the consolidated statement of income at that time. For the quarter ended March 5, 2004, there were no such net gains or losses recognized in other income relating to hedges of forecasted transactions that did not occur.

The critical terms of the cash flow hedging instruments are the same as the underlying forecasted transactions. The changes in fair value of the derivatives are intended to offset changes in the expected cash flows from the forecasted transactions. We record any ineffective portion of the hedging instruments in other income (loss) on the consolidated statement of income. The time value of purchased derivative instruments is deemed to be ineffective and is recorded in other income (loss) over the life of the contract.

**Gain (Loss) on Hedges of Forecasted Transactions:**

	<b>Other Comprehensive Income (Loss)</b>	
	<b>March 5, 2004</b>	<b>November 28, 2003</b>
<b>Balance Sheet</b>		
<b>Recognized but Unrealized—Open Transactions:</b>		
Unrealized net gain (loss) remaining in other comprehensive income (loss) . . . .	<u>\$1,795</u>	<u>\$(867)</u>

	<b>Three Months Ended</b>			
	<b>March 5, 2004</b>		<b>February 28, 2003</b>	
	<b>Revenue</b>	<b>Other Income (Loss)</b>	<b>Revenue</b>	<b>Other Income (Loss)</b>
<b>Income Statement</b>				
<b>Realized—Closed Transactions:</b>				
Realized net loss reclassified from other comprehensive income (loss) to revenue . . . . .	\$ (1,355)	\$ —	\$ (1,702)	\$ —
Realized net loss from the cost of purchased options and gains or losses from any ineffective portion of hedges . . . . .	—	(1,703)	—	(1,032)
<b>Recognized but Unrealized—Open Transactions:</b>				
Unrealized net loss from time value degradation and any ineffective portion of hedges . . . . .	—	(307)	—	(869)
	<u>\$ (1,355)</u>	<u>\$(2,010)</u>	<u>\$ (1,702)</u>	<u>\$(1,901)</u>

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
(In thousands, except share and per share data)  
(Unaudited)

**NOTE 8. FINANCIAL INSTRUMENTS (Continued)**

*Interest Rate Hedging—Hedging of Interest Rate Sensitive Obligations*

We entered into interest rate swap agreements to manage our exposure to operating lease obligations that are tied to short-term interest rates. The swaps allow us to exchange variable interest rate payments for fixed interest rate payments, thereby securing a fixed payment amount for a portion of the total obligation. As of March 5, 2004, we had entered into interest rate swaps to hedge the floating cash flow payments associated with \$121.8 million of our outstanding lease obligations. The swaps mature at various dates in the third quarter of 2004, consistent with the expiration of the underlying facility lease. Under the swap agreements, we will receive a variable rate based on one month LIBOR and pay fixed rates ranging from 3.13% to 5.14%. The impact of these swaps will cap a portion of our rent expense at these levels.

These swaps are designated as cash flow hedges under SFAS No. 133 because they hedge against changes in the amount of future cash flows. As of March 5, 2004, a \$1.8 million unrealized loss was recorded in accumulated other comprehensive income (loss) as a result of the decrease in fair market value of these interest rate hedges. There was no realized gain or loss due to ineffectiveness of the hedges.

*Balance Sheet Hedging—Hedging of Foreign Currency Assets and Liabilities*

We hedge our net recognized foreign currency assets and liabilities with forward foreign exchange contracts to reduce the risk that our earnings and cash flows will be adversely affected by changes in foreign currency exchange rates. These derivative instruments hedge assets and liabilities that are denominated in foreign currencies and are carried at fair value with changes in the fair value recorded as other income (loss). These derivative instruments do not subject us to material balance sheet risk due to exchange rate movements because gains and losses on these derivatives are intended to offset gains and losses on the assets and liabilities being hedged. At March 5, 2004, the outstanding balance sheet hedging derivatives had maturities of 90 days or less.

Net gains recognized in other income (loss) relating to balance sheet hedging for the three months ended March 5, 2004 and February 28, 2003 were as follows:

	<u>2004</u>	<u>2003</u>
Gain (loss) on foreign currency assets and liabilities:		
Realized net gain recognized in other income (loss) . . . . .	\$ 5,581	\$ 5,171
Unrealized net gain (loss) recognized in other income (loss) . .	(2,359)	466
	<u>3,222</u>	<u>5,637</u>
Gain (loss) on hedges of foreign currency assets and liabilities:		
Realized net loss recognized in other income (loss) . . . . .	(11,695)	(3,863)
Unrealized net gain (loss) recognized in other income (loss) . .	8,699	(286)
	<u>(2,996)</u>	<u>(4,149)</u>
Net gain recognized in other income (loss) . . . . .	<u>\$ 226</u>	<u>\$ 1,488</u>

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
(In thousands, except share and per share data)  
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**NOTE 9. COMPREHENSIVE INCOME**

Statement of Financial Accounting Standards No. 130 ("SFAS 130"), "Reporting Comprehensive Income," establishes standards for the reporting and display of comprehensive income and its components in the financial statements. Items of comprehensive income that we currently report are unrealized gains and losses on marketable securities categorized as available-for-sale and foreign currency translation adjustments. We also report gains and losses on derivative instruments qualifying as cash flow hedges such as (i) hedging a forecasted transaction, (ii) the variability of cash flows to be received or paid related to a recognized asset or liability ("cash flow hedge"), (iii) foreign currency cash-flow hedges, or (iv) interest rate hedges.

The following table sets forth the components of comprehensive income, net of income tax expense, for the three months ended March 5, 2004 and February 28, 2003:

	<u>2004</u>	<u>2003</u>
Net income as reported . . . . .	\$123,035	\$54,225
Other comprehensive income (loss), net of tax:		
Change in unrealized gain on available-for-sale securities, net of taxes . . . . .	3,025	1,067
Currency translation adjustments . . . . .	332	1,569
Net gain (loss) in derivative instruments, net of taxes . . . . .	3,224	(2,343)
Other comprehensive income . . . . .	6,581	293
Total comprehensive income, net of taxes . . . . .	<u>\$129,616</u>	<u>\$54,518</u>

**NOTE 10. NET INCOME PER SHARE**

Basic net income per share is computed using the weighted average number of common shares outstanding for the period, excluding unvested restricted stock. Diluted net income per share is based upon the weighted average common shares outstanding for the period plus dilutive common equivalent shares, including unvested restricted common stock and stock options using the treasury stock method.

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
(In thousands, except share and per share data)  
(Unaudited)

**NOTE 10. NET INCOME PER SHARE (Continued)**

The following table sets forth the computation of basic and diluted net income per share for the three months ended March 5, 2004 and February 28, 2003:

	<u>2004</u>	<u>2003</u>
Net income . . . . .	\$123,035	\$ 54,225
Shares used to compute basic net income per share (weighted average shares outstanding during the period, excluding unvested restricted stock) . . . . .	238,384	231,084
Dilutive common equivalent shares:		
Unvested restricted stock . . . . .	17	72
Stock options . . . . .	7,686	4,138
Shares used to compute diluted net income per share . . . . .	246,087	\$235,294
Basic net income per share . . . . .	\$ 0.52	\$ 0.23
Diluted net income per share . . . . .	\$ 0.50	\$ 0.23

For the quarters ended March 5, 2004 and February 28, 2003, options to purchase approximately 12.8 million and 40.9 million shares, respectively, of common stock with exercise prices greater than the average fair market value of our stock of \$38.55 and \$26.78, respectively, were not included in the calculation because the effect would have been antidilutive.

**NOTE 11. INDUSTRY SEGMENTS**

We have four reportable segments that offer different product lines: Digital Imaging and Video, Creative Professional, Intelligent Documents and OEM PostScript and Other. The Digital Imaging and Video segment provides users with software for creating, editing, enhancing and sharing digital images and photographs, digital video, audio and animations. The Creative Professional segment provides software for professional page layout, professional Web page layout, graphic and illustration creation, technical document publishing and business publishing. The Intelligent Documents segment provides electronic document distribution software that allows users to create, enhance, annotate and securely send Adobe PDF files that can be shared, viewed, navigated and printed exactly as intended on a broad range of hardware and software platforms. In addition, this segment provides server-based solutions for enterprises and government agencies in the areas of document generation, document process management, document collaboration, and document control and security. The OEM PostScript and Other segment includes printing technology used to create and print simple or visually rich documents with precision.

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
(In thousands, except share and per share data)  
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**NOTE 11. INDUSTRY SEGMENTS (Continued)**

The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies. With the exception of goodwill, we do not identify or allocate our assets by operating segments. See Note 2 for the allocation of goodwill to our reportable segments.

	Digital Imaging and Video	Creative Professional	Intelligent Documents	OEM PostScript and Other	Total
<b>Quarter ended March 5, 2004</b>					
Revenue . . . . .	\$113,517	\$158,110	\$130,291	\$21,363	\$423,281
Cost of revenue . . . . .	9,276	5,451	8,334	1,121	24,182
Gross profit . . . . .	<u>\$104,241</u>	<u>\$152,659</u>	<u>\$121,957</u>	<u>\$20,242</u>	<u>\$399,099</u>
Gross profit as a percentage of revenues .	92%	97%	94%	95%	94%
<b>Quarter ended February 28, 2003</b>					
Revenue . . . . .	\$ 96,182	\$ 85,863	\$ 90,884	\$23,966	\$296,895
Cost of revenue . . . . .	8,538	6,260	6,112	1,452	22,362
Gross profit . . . . .	<u>\$ 87,644</u>	<u>\$ 79,603</u>	<u>\$ 84,772</u>	<u>\$22,514</u>	<u>\$274,533</u>
Gross profit as a percentage of revenues .	91%	93%	93%	94%	92%

A reconciliation of the totals reported for the operating segments to the applicable line items in the condensed consolidated financial statements for the quarters ended March 5, 2004 and February 28, 2003 is as follows:

	2004	2003
Total gross profit from operating segments above . . . . .	\$399,099	\$274,533
Total operating expenses(*) . . . . .	<u>235,837</u>	<u>194,025</u>
Total operating income . . . . .	163,262	80,508
Non-operating income (loss) . . . . .	<u>3,001</u>	<u>(3,043)</u>
Income before income taxes . . . . .	<u>\$166,263</u>	<u>\$ 77,465</u>

(\*) Total operating expenses comprise research and development, sales and marketing and general and administrative.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion (presented in millions, except share and per share amounts, and is unaudited) should be read in conjunction with the condensed consolidated financial statements and notes thereto.*

*In addition to historical information, this Quarterly Report on Form 10-Q contains forward-looking statements, including statements regarding product plans and investing activities, that involve risks and uncertainties that could cause actual results to differ materially. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in the section entitled "Factors That May Affect Future Performance." You should carefully review the risks described herein and in other documents we file from time to time with the Securities and Exchange Commission, including the Annual Report on Form 10-K for fiscal 2003 and the other Quarterly Reports on Form 10-Q to be filed by us in fiscal 2004. When used in this report, the words "expects," "could," "would," "may," "anticipates," "intends," "plans," "believes," "seeks," "targets," "estimates," "looks for," "looks to," and similar expressions, as well as statements regarding Adobe's focus for the future, are generally intended to identify forward-looking statements. You should not place undue reliance on these forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document.*

### **BUSINESS OVERVIEW**

Founded in 1982, Adobe offers a line of software for consumers, creative professionals and enterprises. Our products enable customers to create, manage and deliver visually rich, compelling and reliable content. We distribute our products through a network of distributors and dealers, VARs, systems integrators, ISVs and OEMs; direct to end users; and through our own Web site at [www.adobe.com](http://www.adobe.com). We also license our technology to major hardware manufacturers, software developers and service providers and we offer integrated software solutions to businesses of all sizes. We have operations in the Americas, EMEA, and Asia. Our software runs on Microsoft Windows, Apple Macintosh, Linux, UNIX and various non-personal computer platforms, depending on the product.

We maintain executive offices and principal facilities at 345 Park Avenue, San Jose, California 95110-2704. Our telephone number is 408-536-6000. We maintain a Web site at [www.adobe.com](http://www.adobe.com). Investors can obtain copies of our SEC filings from this site free of charge, as well as from the SEC Web site at [www.sec.gov](http://www.sec.gov).

### **CRITICAL ACCOUNTING ESTIMATES**

In preparing our consolidated financial statements, we make assumptions, judgments and estimates that can have a significant impact on our net revenue, operating income and net income, as well as on the value of certain assets and liabilities on our consolidated balance sheet. We base our assumptions, judgments and estimates on historical experience and various other factors that we believe to be reasonable under the circumstances. Actual results could differ materially from these estimates under different assumptions or conditions. On a regular basis we evaluate our assumptions, judgments and estimates and make changes accordingly. We believe that the assumptions, judgments and estimates involved in the accounting for revenue recognition, income taxes and valuation of marketable and non marketable equity securities have the greatest potential impact on our consolidated financial statements, so we consider these to be our critical accounting policies. We discuss below the critical accounting estimates associated with these policies. Historically, our assumptions, judgments and estimates relative to our critical accounting policies have not differed materially from actual results. For further information on the critical accounting policies, see Note 1 of our Notes to Condensed Consolidated Financial Statements.

## **Revenue Recognition**

We recognize revenue in accordance with current generally accepted accounting principles that have been prescribed for the software industry. Revenue recognition requirements in the software industry are very complex and are subject to change. Our revenue recognition policy is one of our critical accounting policies because revenue is a key component of our results of operations and is based on complex rules which require us to make judgments and estimates. In applying our revenue recognition policy we must determine which portions of our revenue are recognized currently and which portions must be deferred. In order to determine current and deferred revenue, we make judgments and estimates with regard to future deliverable products and services and the appropriate pricing for those products and services. Our assumptions and judgments regarding future products and services could differ from actual events.

We have to estimate provisions for returns which are recorded against our revenues. In determining our estimate for returns, and in accordance with our internal policy regarding channel inventory, we rely upon historical data, the estimated amount of product in our distribution channel, the rate at which our product sells through to the end user, product plans and other factors. Our estimated provisions for returns can vary from what actually occurs. More or less product may be returned from what was estimated. The amount of inventory in the channel could be different than what is estimated. Our estimate of the rate of sell through for product in the channel could be different than what actually occurs. These factors and unanticipated changes in the economic and industry environment could make our return estimates differ from actual.

## **Income Taxes**

We provide for the effect of income taxes on our financial position and results of operations in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." Under this current accounting pronouncement, income tax expense is recognized for the amount of taxes payable or refundable for the current year and for deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Management must make significant assumptions, judgments and estimates to determine our current provision for income taxes and also our deferred tax assets and liabilities and any valuation allowance to be recorded against our net deferred tax asset. Our judgments, assumptions and estimates relative to the current provision for income tax take into account current tax laws, our interpretation of current tax laws and possible outcomes of current and future audits conducted by foreign and domestic tax authorities. Changes in tax law or our interpretation of tax laws and the resolution of current and future tax audits could significantly impact the amounts provided for income taxes in our financial position and results of operations. Our assumptions, judgments and estimates relative to the value of our net deferred tax asset take into account predictions of the amount and category of future taxable income. Actual operating results and the underlying amount and category of income in future years could render our current assumptions, judgments and estimates of recoverable net deferred taxes inaccurate, thus materially impacting our financial position and results of operations.

## **Marketable and Non-Marketable Equity Securities**

It is our policy to review our equity holdings on a regular basis to evaluate whether or not each security has experienced an other-than-temporary decline in fair value. Our policy includes, but is not limited to, reviewing the cash position, earnings/revenue outlook, stock price performance over the past six months, liquidity and management/ownership of each investment. If we believe that an other-than-temporary decline exists in one of our marketable equity securities, it is our policy to write down these equity investments to the market value and record the related write-down as an investment loss on our consolidated statements of income. The ultimate value realized on these equity investments is subject to market volatility until they are sold.

The stocks of a number of technology investments held both directly and by Adobe Ventures are not publicly traded and, therefore, there is no established market for these securities. In order to determine the fair market value of these investments, we use the most recent round of financing involving new non-strategic investors or other estimates of current market value. It is our policy to review the fair value of these investments held by Adobe Ventures on a regular basis to evaluate the carrying value of the investments in these companies. The evaluation process is based on information we request from these privately held companies. This information is not subject to the same disclosure regulations as U.S. publicly traded companies and as such, the basis for these evaluations is subject to the timing and the accuracy of the data received from these companies. Estimating the fair value of non-marketable equity investments in early-stage technology companies is inherently subjective, requiring significant judgment by management, and may contribute to significant volatility in our reported results.

## RESULTS OF OPERATIONS

### Overview of the Quarter Ended March 5, 2004

During the first quarter of fiscal 2004, we continued to focus on delivering comprehensive technology platforms for enterprises and creative professionals to drive revenue and earnings growth. Our new Acrobat desktop products, released during fiscal 2003, continued to perform well and indicate we are making progress against our Intelligent Documents segment strategy to increase the adoption of Acrobat across several identified markets. Our Intelligent Documents initiatives to deliver a comprehensive server-based platform to help governments and enterprises improve their business processes also have achieved both strong sequential and year-over-year growth. Additionally, our strategy of providing creative professionals a complete design platform is resonating with our customers. The success we achieved in fiscal 2003 in our Creative Professional business segment continued in the first quarter of fiscal 2004 due to strong licensing of our new Adobe Creative Suite and CS products.

We continue to focus on delivering innovative products and solutions for our customers. Our success could be limited by several factors, including the timely release of new products, continued market acceptance of our products, the introduction of new products by existing or new competitors and unfavorable exchange rate fluctuations. For a further discussion of these and other risk factors, see the section titled "Factors That May Affect Future Performance."

### Revenue

The first quarter of fiscal 2004 was 14 weeks in length as compared to 13 weeks in the first quarter of fiscal 2003 due to our 52/53 week fiscal year.

	First Quarter		Percent Change
	2004	2003	
Product . . . . .	\$415.8	\$290.8	43%
Percentage of total revenues . . . . .	98%	98%	
Services and support . . . . .	7.5	6.1	23%
Percentage of total revenues . . . . .	2%	2%	
Total revenues . . . . .	<u>\$423.3</u>	<u>\$296.9</u>	43%

We have four reportable segments that offer different product lines: Digital Imaging and Video, Creative Professional, Intelligent Documents, and OEM PostScript and Other. The Digital Imaging and Video segment provides users with software for creating, editing, enhancing and sharing digital images and photographs, digital video, audio and animations. The Creative Professional segment provides software for professional page layout, professional Web page layout, graphic and illustration creation, technical document publishing and business publishing. The Intelligent Documents segment provides electronic



document distribution software that allows users to create, enhance, annotate and securely send Adobe PDF files that can be shared, viewed, navigated and printed exactly as intended on a broad range of hardware and software platforms. In addition, this segment provides server-based solutions for enterprises and government agencies in the areas of document generation, document process management, document collaboration, and document control and security. The OEM PostScript and Other segment includes printing technology used to create and print simple or visually rich documents with precision.

Our services and support revenue is composed of professional services (such as consulting services and training) and maintenance and support, primarily related to the licensing of our Intelligent Documents server solution products. Our support revenue also includes technical support and developer support to partners and developer organizations related to our desktop products. Our professional services revenue is recognized using the percentage of completion method and is measured monthly based on input measures, such as on hours incurred to date compared to total estimated hours to complete, with consideration given to output measures, such as contract milestones, when applicable. Our maintenance and support offerings, which entitle customers to receive product upgrades and enhancements or technical support, depending on the offering, is recognized ratably over the term of the arrangement.

#### *Segment revenues*

	<b>First Quarter</b>		<b>Percent Change</b>
	<b>2004</b>	<b>2003</b>	
Digital Imaging and Video . . . . .	\$113.5	\$ 96.2	18%
Percentage of total revenues . . . . .	27%	32%	
Creative Professional . . . . .	158.1	85.8	84%
Percentage of total revenues . . . . .	37%	29%	
Intelligent Documents* . . . . .	130.3	90.9	43%
Percentage of total revenues . . . . .	31%	31%	
OEM PostScript and Other . . . . .	21.4	24.0	(11)%
Percentage of total revenues . . . . .	5%	8%	
Total revenues . . . . .	<u>\$423.3</u>	<u>\$296.9</u>	43%

\* The Intelligent Documents segment includes services and support revenue.

Revenue from our Digital Imaging and Video segment increased during the first quarter of fiscal 2004 as compared to the first quarter of fiscal 2003 primarily due to an increase in revenues from our digital imaging software products. Overall, revenue from our digital imaging software products increased 18% which was mainly attributable to the release of Photoshop CS as well as a strong holiday season demand for the Photoshop Elements and Photoshop Album retail bundle. Revenue from our digital video software products increased by 20%, due primarily to success with software products newly released in the second half of fiscal 2003.

Revenue from our Creative Professional segment increased during the first quarter of fiscal 2004 as compared to the first quarter of fiscal 2003 primarily due to the increase in revenues from our Creative Suite and illustration software products which were initially released in the fourth quarter of fiscal 2003. This increase was partially offset by decreases in revenues from our layout software products in the Creative Professional segment due to the planned migration of customers to Adobe Creative Suite.

Revenue from our Intelligent Documents segment increased during the first quarter of fiscal 2004 as compared to the first quarter of fiscal 2003 primarily due to the 44% increase in revenues from our Acrobat desktop products. The increase in revenues from our Acrobat desktop products is due to continued adoption of Acrobat desktop products. Additionally, revenue from our Intelligent Documents

server-based products increased 38% due to increased licensing in both the government and enterprise markets and increased server support revenue.

Revenue from our OEM PostScript and Other segment decreased during the first quarter of fiscal 2004 as compared to the first quarter of fiscal 2003 primarily due to a decline in pricing resulting from competition from clone PostScript technologies.

#### *Geographical revenues*

	<b>First Quarter</b>		<b>Percent Change</b>
	<b>2004</b>	<b>2003</b>	
Americas . . . . .	\$183.5	\$146.5	25%
Percentage of total revenues . . . . .	43%	49%	
EMEA . . . . .	144.1	89.3	61%
Percentage of total revenues . . . . .	34%	30%	
Asia . . . . .	95.7	61.1	57%
Percentage of total revenues . . . . .	23%	21%	
Total revenues . . . . .	<u>\$423.3</u>	<u>\$296.9</u>	43%

Revenue in the Americas, EMEA and Asia increased during the first quarter of fiscal 2004 from the same period last year due to the strength of our Creative Professional and Intelligent Documents products. Additionally, revenues in EMEA and Asia increased approximately \$29 million due to the strength of the euro and the yen.

Total application platform mix (excluding platform independent and UNIX revenues) for the first quarter of fiscal 2004 was split 71% on Windows and 29% on Macintosh as compared to 74% and 26%, respectively, for the first quarter of fiscal 2003. Macintosh application revenue increased in recent quarters due to the successful launch of our Creative Professional applications, including Adobe Creative Suite and new CS versions of Illustrator, InDesign and Photoshop, which have large Macintosh customer bases. However, we expect the growth trend towards the Windows platform to continue over the long term due to our targeting of business users with our Intelligent Documents desktop products, where the significant majority of users run the Windows operating system.

In Adobe's experience, the actual amount of product backlog at any particular time is not a meaningful indicator of our future business prospects. Prior to major product releases, we tend to have significant levels of backlog, but at other times backlog is minimal and we normally ship products within a few days of receiving an order, subject to credit verification and the targeted global channel inventory position under our global channel inventory policy. Backlog is also subject to variability beyond the targeted global channel inventory position under our global channel inventory policy at the end of a reporting period, in amounts usually less than 5% of reported revenue. At the end of the first quarter, our backlog beyond the targeted channel inventory position was higher than usual.

Our channel inventory position was below company policy at the end of the first quarter of fiscal 2004. Despite stronger than typical backlog of channel orders at the end of the first quarter of fiscal 2004, we elected to take what we believe to be a more conservative approach regarding channel inventory levels. We made this decision due to the lack of history associated with the sell-through of the new Adobe Creative Suite products, combined with typical softer seasonal demand in the Spring.

## Cost of Revenue

	First Quarter		Percent Change
	2004	2003	
Product . . . . .	\$20.4	\$19.4	6%
Percentage of total revenues . . . . .	5%	7%	
Services and support . . . . .	3.7	3.0	25%
Percentage of total revenues . . . . .	1%	1%	
Total cost of revenue . . . . .	<u>\$24.1</u>	<u>\$22.4</u>	8%

Cost of product revenue includes product packaging, third-party royalties, excess and obsolete inventory, amortization related to localization costs and acquired technologies and the costs associated with the manufacturing of our products.

Cost of product revenue increased in the first quarter of fiscal 2004 as compared to the first quarter of fiscal 2003 due to increased excess and obsolete inventory expenses as a result of major product launches at the end of fiscal 2003. Cost of product revenue also increased due to the following factors: an additional week of expenses in the first quarter of fiscal 2004, increased royalty fees and localization costs related to our product launches in the latter part of fiscal 2003 and the first quarter of fiscal 2004 and higher amortization of purchased technology related to our asset acquisition from Syntrillium. These increases were partially offset by lower material costs due to product mix and our successful cost reduction efforts.

Cost of services and support revenue is composed primarily of employee-related costs and the related costs incurred to provide consulting services, training and product support.

Cost of services and support revenue increased in the first quarter of fiscal 2004 as compared to the same period in the prior fiscal year due primarily to several severance compensation and related benefits associated with a reduction in professional services headcount and increased compensation and related benefits due to an extra week of expenses in the first quarter of fiscal 2004.

## Operating Expenses

	First Quarter		Percent Change
	2004	2003	
Research and development . . . . .	\$75.1	\$66.0	14%
Percentage of total revenues . . . . .	18%	22%	

Research and development expenses consist of salary and benefit expenses for software developers, contracted development efforts, related facilities costs and expenses associated with computer equipment used in software development.

Research and development expenses increased 13% in the first quarter of fiscal 2004 as compared to the first quarter of fiscal 2003 due to higher compensation and related benefits primarily because of an additional week of expenses in the first quarter of fiscal 2004 as well as increases in headcount and incentive compensation. The remaining 1% increase in research and development expenses was due to various individually insignificant items.

We believe that investments in research and development, including the recruiting and hiring of software developers, are critical to remain competitive in the marketplace and are directly related to continued timely development of new and enhanced products. We will continue to focus on long-term

opportunities available in our end markets and make significant investments in the development of our desktop application and server-based software products.

	<u>First Quarter</u>		<u>Percent</u>
	<u>2004</u>	<u>2003</u>	<u>Change</u>
Sales and marketing . . . . .	\$127.4	\$98.0	30%
Percentage of total revenues . . . . .	30%	33%	

Sales and marketing expenses include salary and benefit expenses, sales commissions, travel expenses and related facilities costs for our sales, marketing, customer support, order management and order fulfillment personnel. Sales and marketing expenses also include the costs of programs aimed at increasing revenue, such as advertising, trade shows, public relations and other market development programs.

Sales and marketing expenses increased 15% in the first quarter of fiscal 2004 as compared to the first quarter of fiscal 2003 due to higher compensation and related benefits primarily because of an additional week of expenses in the first quarter of fiscal 2004 as well as increases in headcount and incentive compensation. Sales and marketing expenses also increased 13% due to higher marketing and advertising expenses related to various product launches and marketing campaigns during the first quarter of fiscal year 2004. The remaining 2% increase in sales and marketing expenses was due to various individually insignificant items.

	<u>First Quarter</u>		<u>Percent</u>
	<u>2004</u>	<u>2003</u>	<u>Change</u>
General and administrative . . . . .	\$33.4	\$30.0	11%
Percentage of total revenues . . . . .	8%	10%	

General and administrative expenses consist principally of salary and benefit expenses, directors and officers' insurance, travel expenses, and related facilities costs for our finance, human resources, legal, information services and executive personnel. General and administrative expenses also include outside legal and accounting fees, provision for bad debts, and expenses associated with computer equipment and software used in the administration of the business.

General and administrative expenses increased 20% in the first quarter of fiscal 2004 as compared to the first quarter of fiscal 2003 due to higher compensation and related benefits primarily because of an additional week of expenses in the first quarter of fiscal 2004 as well as increases in headcount and incentive compensation. This increase was partially offset by a 9% decrease in general and administrative expenses due to a decrease in the provision for bad debts resulting from the settlement of an account.

## Non-operating Income

	<u>First Quarter</u>		<u>Percent</u>
	<u>2004</u>	<u>2003</u>	<u>Change</u>
Investment loss . . . . .	\$(1.0)	\$(6.7)	(85)%
Percentage of total revenues . . . . .	—%	(2)%	
Interest and other income . . . . .	4.0	3.6	11%
Percentage of total revenues . . . . .	1%	1%	
Total non-operating income . . . . .	<u>\$ 3.0</u>	<u>\$(3.1)</u>	*%

\* Percentage is not meaningful

### *Investment Loss*

Investment loss consists principally of realized gains or losses from the sale of marketable equity investments, other-than-temporary declines in the value of marketable and non-marketable equity securities and gains and losses of Adobe Ventures.

During the first quarter of fiscal 2004, investment losses primarily comprised losses related to our Adobe Ventures and our cost method investments totaling \$1.2 million. These losses were partially offset by gains on our short-term investments of \$0.2 million.

During the first quarter of fiscal 2003, investment losses included other-than-temporary write-downs of \$3.9 million related to our short-term investments in Viewpoint Corporation, Salon Media Group, Inc. and Virage, Inc. Investment losses also included losses related to our Adobe Ventures and our cost method investments totaling \$3.6 million. These losses were partially offset by gains from the sale of our marketable equity securities of \$0.8 million.

We are uncertain of future investment gains or losses as they are primarily dependent upon the operations of the underlying companies and market valuations. These marketable equity securities are inherently risky investments and we may experience further deterioration in fair value in the future.

### *Interest and Other Income*

The largest component of interest and other income is interest earned on cash, cash equivalents and short-term fixed income investments, but also includes gains and losses on the sale of fixed income investments, foreign exchange transaction gains and losses, and interest expense.

Interest and other income increased during the first quarter of fiscal 2004 as compared to fiscal 2003 due to increased interest income as a result of higher levels of cash during the first quarter of fiscal 2004 and an extra week in the quarter.

### **Provision for Income Taxes**

	<b>First Quarter</b>		<b>Percent Change</b>
	<b>2004</b>	<b>2003</b>	
Provision for income taxes . . . . .	\$43.2	\$23.2	86%
Percentage of total revenues . . . . .	10%	8%	
Effective tax rate . . . . .	26%	30%	

Our effective tax rate decreased in the first quarter of fiscal 2004 as compared to the same period last year due to higher international profits which are taxed at a lower effective tax rate.

## FACTORS THAT MAY AFFECT FUTURE PERFORMANCE

As aforementioned, our actual results could differ materially from our forward looking statements. Factors that might cause or contribute to such differences include, but are not limited to, those discussed below. These and many other factors described in this report could adversely affect our operations, performance and financial condition.

### *Adverse changes in general economic or political conditions in any of the major countries in which we do business*

If the economy worsens in any geographic areas where we do business, it would likely cause our future results to vary materially from our targets. A slower economy may also adversely affect our ability to grow. Political instability in any of the major countries in which we do business may also adversely affect our business.

### *Delays in development or shipment of our new products or major new versions of existing products*

Any delays or failures in developing and marketing our products, including upgrades of current products, may have a harmful impact on our results of operations. Our inability to extend our core technologies into new applications and new platforms and to anticipate or respond to technological changes could affect our ability to develop new products. A portion of our future revenue will come from new applications. Delays in product or upgrade introductions could cause a decline in our revenue, earnings or stock price. We cannot determine the ultimate effect these delays or the introduction of new products or upgrades will have on our revenue or results of operations.

### *Introduction of new products by existing and new competitors, particularly Microsoft*

The end markets for our software products are intensely and increasingly competitive, and are significantly affected by product introductions and market activities of industry competitors. In the markets served by our Intelligent Documents business, Microsoft has recently launched a new electronic form tool called InfoPath as part of the new version of their professional Office product. We believe that Microsoft's new InfoPath product competes with certain aspects of our Intelligent Documents product line. Given Microsoft's market dominance, InfoPath, or any new competitive Microsoft product or technology that is bundled as part of their Office product or operating system, could harm our overall Intelligent Documents market opportunity. In addition, Microsoft is working on the next generation of its Windows operating system, codenamed Longhorn. It is anticipated that Microsoft will add new electronic document capabilities to Longhorn, potentially providing additional competition to our Intelligent Document products and solutions. Furthermore, Microsoft has increased its presence in the low-end and mid-range consumer digital imaging markets. If competing Microsoft products achieve widespread acceptance, our operating results could suffer. In addition, consolidation has occurred among some of the competitors in our markets. Any further consolidations among our competitors may result in stronger competitors and may therefore harm our results of operations.

### *Difficulties in transitions to new business models or markets*

We are devoting significant resources to the development of technologies and service offerings to address demands in the marketplace for document generation, document process management, document collaboration, and document control and security. As a result, we are transitioning to new business models and seeking to broaden our customer base in the enterprise and government markets, requiring a considerable investment of technical, financial and sales resources. Many of our competitors may have advantages over us due to their larger presence, deeper experience in the enterprise and government markets, and greater sales and marketing resources. It is our intent to form strategic alliances with leading enterprise and government solutions and service providers to provide additional resources to further

enable penetration of the enterprise and government markets. If we are unable to successfully enter into strategic alliances, or if they are not as productive as we anticipate, our market penetration may not proceed as rapidly as we anticipate and our results of operations could be negatively impacted.

We recently launched our Adobe Creative Suite products. Our limited operating history with these products makes it difficult to predict the revenue effect of the Adobe Creative Suite product cycle and the individual products integrated within the Adobe Creative Suite.

#### *Changes in demand for application software, computers and printers*

We offer our application-based products primarily on Windows and Macintosh platforms and on some UNIX platforms. We generally offer our server-based products, but not desktop products, on the Linux platform as well as the Windows and UNIX platforms. To the extent that there is a slowdown of customer purchases of personal computers on either the Windows or Macintosh platform or in general, or to the extent that significant demand arises for our products or competitive products on the Linux desktop platform before we choose and are able to offer our products on this platform, our business could be harmed.

#### *Intellectual property disputes and litigation*

In connection with the enforcement of our own intellectual property rights or in connection with disputes relating to the validity or alleged infringement of third-party rights, we have been, are currently and may in the future be subject to claims, negotiations or complex, protracted litigation as part of our policy to vigorously defend our intellectual property rights, including rights derived from third-party licensors. Intellectual property disputes and litigation are typically very costly and can be disruptive to our business operations by diverting the attention and energies of management and key technical personnel. Although we have successfully defended or resolved past litigation and disputes, we may not prevail in any ongoing or future litigation and disputes. Adverse decisions in such litigation or disputes could have negative results, including subjecting us to significant liabilities, requiring us to seek licenses from others, preventing us from manufacturing or licensing certain of our products, or causing severe disruptions to our operations or the markets in which we compete, any one of which could seriously harm our business. Additionally, although we actively pursue software pirates as part of our enforcement of our intellectual property rights, we do lose revenue due to illegal use of our software. If piracy activities increase, it may further harm our business.

#### *Changes to our distribution channel*

We distribute our application products primarily through distributors, resellers, retailers and increasingly systems integrators, ISVs and VARs (collectively referred to as “distributors”). A significant amount of our revenue for application products is from two distributors. In addition, our channel program now focuses our efforts on larger distributors, which has resulted in our dependence on a relatively small number of distributors licensing a large amount of our products. Our distributors sell our competitors’ products; if our distributors favor our competitors’ products for any reason, they may fail to market our products as effectively or to devote resources necessary to provide effective sales, which would cause our results to suffer. In addition, the financial health of these distributors and our continuing relationships with them are becoming more important to our success. Some of these distributors may be unable to withstand adverse changes in business conditions. Our business could be seriously harmed if the financial condition of some of these distributors substantially weakens.

#### *Malicious code such as worms and viruses could impact our computer network and applications*

Malicious code, such as worms and viruses, are released into the public Internet using recently discovered vulnerabilities in popular software programs. The documents created by our applications, even

those with security features, are also vulnerable to malicious acts such as hacking. Although we have a response team that is notified of high-risk malicious events from multiple sources and we take certain preventative measures, these procedures may not be sufficient to avoid harm to our business.

*Interruptions or terminations in our relationships with our turnkey assemblers*

We currently rely on six turnkey assemblers of our products, with at least two turnkeys located in each major region we serve. If any significant turnkey assembler terminates its relationship with us, or if our supply from any significant turnkey assembler is interrupted or terminated for any other reason, we may not have enough time or be able to replace the supply of products manufactured by that turnkey assembler to avoid serious harm to our business.

*Our future operating results are difficult to predict and are likely to fluctuate substantially from quarter to quarter*

As a result of a variety of factors discussed herein, our quarterly revenues and operating results for a particular period are extremely difficult to predict. Our revenues may grow at a slower rate than experienced in previous periods and, in particular periods, may decline. Additionally, we periodically provide operating model targets for revenue, gross margin, operating expenses, operating margin, other income, tax rate, share count and earnings per share. These targets reflect a number of assumptions, including assumptions about product pricing and demand, economic and seasonal trends, manufacturing costs and volumes and the mix of application products and licensing revenue, full and upgrade products, distribution channels and geographic markets. If one or more of these assumptions prove incorrect, our actual results may vary materially from those anticipated, estimated or projected.

*Fluctuations in foreign currency exchange rates*

Our operating results are subject to fluctuations in foreign currency exchange rates. We attempt to mitigate a portion of these risks through foreign currency hedging, based on our judgment of the appropriate trade-offs among risk, opportunity and expense. We have established a hedging program to hedge our exposure to foreign currency exchange rate fluctuations, primarily the Japanese yen and the euro. We regularly review our hedging program and will make adjustments based on our judgment. Our hedging activities may not offset more than a portion of the adverse financial impact resulting from unfavorable movement in foreign currency exchange rates.

*Changes in accounting rules*

We prepare our financial statements in conformity with accounting principles generally accepted in the United States of America. These principles are subject to interpretation by the Securities and Exchange Commission (the “SEC”) and various bodies formed to interpret and create appropriate accounting policies. A change in these policies can have a significant effect on our reported results and may even retroactively affect previously reported transactions. Our accounting policies that recently have been or may be affected by changes in the accounting rules are as follows:

- software revenue recognition
- accounting for stock-based compensation
- accounting for goodwill and other intangible assets
- accounting for guarantees and indemnities
- accounting for variable interest entities

In particular, FASB guidelines relating to accounting for goodwill could make our acquisition-related charges less predictable in any given reporting period. It is possible that in the future, we may incur less



frequent, but larger, impairment charges related to goodwill we have already recorded, as well as goodwill arising out of potential future acquisitions. Changes to these rules or the questioning of current practices may have a significant adverse effect on our reported financial results or in the way in which we conduct our business.

#### *Unanticipated changes in tax rates*

Unanticipated changes in our tax rates could affect our future results of operations. Our future effective tax rates could be unfavorably affected by changes in tax laws or the interpretation of tax laws, by unanticipated decreases in the amount of revenue or earnings in countries with low statutory tax rates, or by changes in the valuation of our deferred tax assets and liabilities.

In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other domestic and foreign tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our operating results and financial position.

#### *Market risks associated with our equity investments (as discussed later under “Quantitative and Qualitative Disclosures about Market Risk”)*

We hold equity investments in public companies that have experienced significant declines in market value. We also have investments and may continue to make future investments in privately held companies, many of which are considered in the start-up or development stages. These investments are inherently risky, as the market for the technologies or products these companies have under development is typically in the early stages and may never materialize. Our investment activities can impact our net income. Future price fluctuations in these securities and any significant long-term declines in value of any of our investments could reduce our net income in future periods. We are uncertain about future investment gains and losses, as they are primarily dependent upon the operations of the underlying investee companies.

#### *Our inability to attract and retain key personnel*

We plan to recruit key talent for our future growth, especially to support our enterprise business. Competition for such high-quality personnel, especially highly skilled engineers, is intense. Our ability to effectively manage this growth will require us to continue to improve our operational and financial controls and information management systems; otherwise, our business could be seriously harmed. We rely on equity compensation in order to recruit and retain highly skilled employees in a competitive environment. If we are unable to provide adequate equity compensation incentives to effectively recruit and retain talented employees, our business may be harmed.

Due to the factors noted above, our future earnings and stock price may be subject to volatility, particularly on a quarterly basis. Any shortfall in revenue or earnings or any delay in the release of any product or upgrade compared to analysts’ or investors’ expectations has caused and could cause in the future an immediate and significant decline in the trading price of our common stock. Additionally, we may not learn of such shortfalls or delays until late in the fiscal quarter, which could result in an even more immediate and greater decline in the trading price of our common stock. Finally, we participate in a highly dynamic industry. In addition to factors specific to us, changes in analysts’ earnings estimates for us or our industry, and factors affecting the corporate environment, our industry, or the securities markets in general, will often result in volatility of our common stock price.

## EMPLOYEE AND DIRECTOR STOCK OPTIONS

### Option Program Description

Our stock option program is a long-term retention program that is intended to attract, retain and provide incentives for talented employees, officers and directors, and to align stockholder and employee interests. We consider our option programs critical to our operation and productivity; essentially all of our employees participate. Currently, we grant options from the 1) 2003 Equity Incentive Plan (“2003 Plan”), under which options could be granted to all employees, including executive officers, and outside consultants and 2) the 1996 Outside Directors Stock Option Plan, as amended, under which options are granted automatically under a pre-determined formula to non-employee directors. In addition, our stock option program includes the Adobe 1984 Stock Option Plan, as amended, and the Aldus 1984 Restated Stock Option Plan from which we currently do not grant options. The plans listed above are collectively referred to in the following discussion as “the Plans.” Option vesting periods are generally three years for all of the Plans.

All stock option grants to current executive officers are made after a review by and with the approval of the Executive Compensation Committee of the Board of Directors. All members of the Executive Compensation Committee are independent directors, as defined in the current and proposed rules applicable to issuers traded on the Nasdaq Stock Market. See the “Report of the Executive Compensation Committee” appearing in the Company’s 2004 Proxy Statement for further information concerning the policies and procedures, of the Company and the Executive Compensation Committee, regarding the use of stock options.

### Distribution and Dilutive Effect of Options

The table below provides information about stock options granted to our Chief Executive Officer and our four other most highly compensated executive officers, as identified in our 2004 Proxy Statement. This group is referred to as the Named Executive Officers. Please refer to the section headed “Stock Option Exercises and Option Holdings” below for the Named Executive Officers.

Options granted to employees, directors and Named Executive Officers for the first quarter of fiscal 2004 and for fiscal year 2003 are summarized as follows:

	<u>2004</u>	<u>2003</u>
Net grants(1) during the period as % of outstanding shares . . . . .	2%	(3)%
Net grants to Named Executive Officers during the period as % of total options granted . .	0%	0%
Net grants to Named Executive Officers during the period as % of outstanding shares . . . .	0%	0%
Cumulative options held by Named Executive Officers as % of total options outstanding . .	15%	16%

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- (1) “Net grants” equals the sum of the number of shares subject to options granted to all employees, directors and Named Executive Officers during the specified period reduced by the number of shares subject to options which were canceled or otherwise terminated during such period. Net grants during fiscal 2003 reflects the cancellation of options under our stock option exchange program. Net grants as a percentage of outstanding shares are based on 238.6 million shares and 238.3 million shares of our common stock outstanding as of March 5, 2004 and November 28, 2003, respectively.

## General Option Information

The following table sets forth the summary of option activity under our stock option program:

	Three Months Ended March 5, 2004			Year Ended November 28, 2003		
	Options Available for Grant	Number of Options Outstanding	Weighted Average Exercise Price	Options Available for Grant	Number of Options Outstanding	Weighted Average Exercise Price
Beginning of period . . . . .	12,953,370	42,469,653	\$32.80	5,566,971	57,847,050	\$35.64
Granted . . . . .	(4,068,462)	4,068,462	39.16	(1,994,130)	1,994,130	33.12
Exercised . . . . .	—	(1,119,721)	23.69	—	(7,978,054)	23.81
Canceled . . . . .	365,613	(365,613)	40.59	9,388,535	(9,393,473)	58.00
Expired . . . . .	(120)	—	—	(8,006)	—	—
End of period . . . . .	<u>9,250,401</u>	<u>45,052,781</u>	<u>\$33.54</u>	<u>12,953,370</u>	<u>42,469,653</u>	<u>\$32.80</u>

The following table sets forth a comparison as of March 5, 2004, of the number of shares subject to outstanding options with exercise prices at or below the closing price of our common stock on March 5, 2004 (“In-the-Money” options) to the number of shares subject to outstanding options with exercise prices greater than the closing price of our common stock on such date (“Out-of-the-Money” options):

	Exercisable	Unexercisable	Total	Percentage of Total Options Outstanding
In-the-Money* . . . . .	21,362,586	9,926,628	31,289,214	69%
Out-of-the-Money . . . . .	8,108,882	5,654,685	13,763,567	31%
Total Options Outstanding . . . . .	<u>29,471,468</u>	<u>15,581,313</u>	<u>45,052,781</u>	<u>100%</u>

\* The closing price of our common stock was \$36.46 on March 5, 2004, as reported by the Nasdaq National Market.

## Named Executive Officer Option Grants

We did not grant any stock options to our Named Executive Officers in the first quarter of fiscal 2004.

## Stock Option Exercises and Option Holdings

The following table shows stock options exercised by the Named Executive Officers in the first quarter of fiscal 2004, including the total value of gains on the date of exercise based on actual sale prices or on the closing price that day if the shares were not sold that day, in each case less the exercise price of the stock options. In addition, the number of shares covered by both exercisable and non-exercisable stock options, as of March 5, 2004, is shown. Also reported are the values for “In-the-Money” options. The dollar amounts shown in the “In-the-Money” column represent the positive spread between the exercise price of

any such existing stock options and closing price as of March 5, 2004 of our common stock. (in actual shares and dollars)

Name	Number of Shares Acquired Upon Exercise	Value Realized Upon Exercise(1)	Number of Securities Underlying Unexercised Options at March 5, 2004		Value of Unexercised In-the-Money Options at March 5, 2004(2)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Bruce R. Chizen . . .	—	\$ —	2,058,447	751,044	\$5,650,705	\$7,422,929
Shantanu Narayen .	—	—	1,069,465	427,085	3,431,909	4,226,579
Murray J. Demo . . .	—	—	855,581	402,086	2,145,139	3,988,839
Jim Stephens . . . . .	50,000	677,391	532,916	264,586	985,372	2,615,214
James Heeger . . . . .	—	—	218,750	331,250	936,563	2,060,438

(1) The “value realized” represents the total value of gains on the date of exercise based on actual sale prices or on the closing price that day if the shares were not sold that day, in each case less the exercise price of the stock options. See related Section 16 filings for detailed information on dispositions of shares.

(2) Option values are based on \$36.46, the closing price of our common stock on March 5, 2004, as reported by the Nasdaq National Market.

### Equity Compensation Plan Information

The following table gives information about our common stock that may be issued upon the exercise of options under our existing equity compensation plans as of March 5, 2004:

Plan Category(1)	Equity Compensation Plan Information		
	Number of securities to be issued upon exercise of outstanding options (a)	Weighted average exercise price of outstanding options (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders . . . . .	45,047,805	\$33.54	25,593,390(2)

(1) The information presented in this table excludes options assumed by Adobe in connection with acquisitions of other companies. As of March 5, 2004, 4,976 shares of our common stock were issuable upon the exercise of these assumed options, at a weighted average exercise price of \$6.82 per share.

(2) Includes 13.6 million shares that are reserved for issuance under the 1997 Employee Stock Purchase Plan.

### LIQUIDITY AND CAPITAL RESOURCES

	March 5, 2004	November 28, 2003	Percent Change
Cash, cash equivalents and short-term investments . . . . .	\$1,249.3	\$1,096.5	14%
Working capital . . . . .	\$1,022.3	\$ 892.5	15%
Stockholders’ equity . . . . .	\$1,217.5	\$1,100.8	11%

Our primary source of cash is receipts from revenue. The primary uses of cash are payroll (salaries, bonuses, and benefits), general operating expenses (marketing, travel, office rent) and cost of product revenue. Another source of cash is proceeds from the exercise of employee options and another use of cash is our stock repurchase program, which is detailed below.

Net cash provided by operating activities for the first quarter of fiscal 2004 of \$185.5 million increased from cash provided in the first quarter of fiscal 2003 of \$79.3 million. Net cash was provided by net income, net of non-cash related expenses of \$40.8 million. Working capital sources of cash were a decrease in accounts receivable and an increase in accrued expenses. Our days sales outstanding in receivables (“DSO”) decreased from 41 days to 28 days. Our accounts receivable and DSO decreased due to shipments occurring earlier in the quarter and increased levels of cash collections. Accrued expenses increased primarily due to compensation costs and sales and marketing programs. Working capital uses of cash included a decrease in income taxes payable due to tax payments made for fiscal 2003 tax liabilities.

Net cash used for investing activities for the first quarter of fiscal 2004 of \$157.7 million increased from cash used in the first quarter of fiscal 2003 of \$88.1 million primarily due to purchases of short-term investments, net of maturities and sales. The increase in investing activities was due to an increase in operational cash flows. We expect to continue to invest in short-term investments and purchase additional property and equipment to support our growth.

Net cash used for financing activities for the first quarter of fiscal 2004 of \$18.2 million decreased from cash used in the first quarter of fiscal 2003 of \$34.4 million. During the first quarter of fiscal 2004, we repurchased 1.4 million shares as compared to 1.6 million shares in the same quarter last year. Cash used for stock repurchased in the first quarter of fiscal 2004 increased from the same period in fiscal 2003 due to a higher average cost per share. The cost of the repurchases was partially offset by proceeds received from employees exercising their stock options. The increase in proceeds received is due to a higher number of options being exercised as well as higher option exercise prices.

We have paid cash dividends on our common stock each quarter since the second quarter of 1988. Adobe’s Board of Directors declared a cash dividend on our common stock of \$0.0125 per common share for the first quarter of fiscal 2004. Under the terms of our lease agreements for our San Jose headquarters, we are not prohibited from paying cash dividends unless an event of default occurs. The declaration of future dividends, whether in cash or in-kind, is within the discretion of Adobe’s Board of Directors and will depend on business conditions, our results of operations and financial condition, and other factors.

We expect to continue our investing activities, including investments in short-term and long-term investments and purchases of computer systems for research and development, sales and marketing, product support, and administrative staff. Furthermore, cash reserves may be used to repurchase stock under our stock repurchase programs and strategically acquire companies, products or technologies that are complementary to our business.

Adobe uses highly regarded investment management firms to manage most of our invested cash. External investment firms actively managed 91% of Adobe’s invested balances during the first quarter of 2004. The fixed income portfolio is primarily invested in municipal bonds within the U.S. and in highly rated corporate and sovereign obligations outside of the U.S. The balance of the fixed income portfolio is managed internally and invested primarily in money market funds for working capital purposes. All investments are made according to guidelines and within compliance of policies approved by the Board of Directors.

Our existing cash, cash equivalents, and investment balances may decline during fiscal 2004 in the event of further weakening of the economy or changes in our planned cash outlay. However, based on our current business plan and revenue prospects, we believe that our existing balances together with our anticipated cash flows from operations will be sufficient to meet our working capital and operating resource expenditure requirements for the next twelve months. Cash from operations could be affected by various risks and uncertainties, including, but not limited to the risks detailed in the section “Factors That May Affect Future Performance.” Also, while we currently have no committed lines of credit, we believe that our banking relationships and good credit should afford us the opportunity to raise sufficient debt in the bank or public market, if required.

### **Stock Repurchase Program I—On-going Dilution Coverage**

To facilitate our stock repurchase program designed to minimize dilution from stock issuance primarily from employee stock plans, we have historically repurchased shares in the open market, sold put warrants and purchased call options.

Authorization to repurchase shares to cover on-going dilution is not subject to expiration. However, this repurchase program is limited to covering net dilution from stock issuances and is subject to business conditions and cash flow requirements as determined by our Board of Directors from time to time. Refer to Part II, Item 2e for share repurchases during the quarter ended March 5, 2004.

On March 29, 2004, we entered into a stock purchase agreement with a large financial institution. Under this agreement, we have provided the financial institution with an up-front payment of \$50 million and the financial institution has agreed to deliver to us at certain intervals during the contract term a number of our shares based on the volume weighted average price during such intervals less a specified discount. The contract expires on or before June 29, 2004.

### **Stock Repurchase Program II—Additional Authorization above Dilution Coverage**

On September 25, 2002, our Board of Directors authorized a program to purchase up to an additional 5.0 million shares of our common stock over a three-year period, subject to certain business and cash flow requirements. We have not made any purchases under this 5.0 million share repurchase program. The authorization for this program will expire in September 2005.

### **Off-Balance Sheet Arrangements and Aggregate Contractual Obligations**

Our principal commitments as of March 5, 2004 consist of obligations under operating leases, royalty agreements and various service agreements. See Note 7 of our Notes to Condensed Consolidated Financial Statements for more detailed information.

#### *Lease Commitments*

The two lease agreements discussed in Note 7 of our Notes to Condensed Consolidated Financial Statements are subject to standard financial covenants. The agreements limit the amount of indebtedness we can incur. A leverage covenant requires us to keep our debt to EBITDA ratio less than 2.5:1.0. As of March 5, 2004 our debt to EBITDA ratio was 0.48, well within the limit. We also have a liquidity covenant which requires us to maintain a quick ratio equal to or greater than 1.0. As of March 5, 2004, our quick ratio was 2.4, well above the minimum. We expect to remain within compliance in the next 12 months. We are comfortable with these limitations and believe they will not impact our cash or credit in the coming year or restrict our ability to execute our business plan.

#### *Indemnifications*

In the normal course of business, we provide indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our products. Historically, costs related to these indemnification provisions have not been significant and we are unable to estimate the maximum potential impact of these indemnification provisions on our future results of operations.

We have commitments to make certain milestone and/or retention payments typically entered into in conjunction with various acquisitions, for which we have made accruals in our consolidated financial statements. In connection with our purchases of technology assets during fiscal 2003, we entered into employee retention agreements totaling \$2.2 million. We are required to make payments upon satisfaction of certain conditions in the agreements.

As permitted under Delaware law, we have agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have director and officer insurance coverage that limits our exposure and enables us to recover a portion of any future amounts paid. We believe the estimated fair value of these indemnification agreements in excess of applicable insurance coverage is minimal.

As part of our limited partnership interests in Adobe Ventures, we have provided a general indemnification to Granite Ventures, an independent venture capital firm and sole general partner of Adobe Ventures, for certain events or occurrences while Granite Ventures is, or was serving, at our request in such capacity provided that Granite Ventures acts in good faith on behalf of the partnerships. We are unable to develop an estimate of the maximum potential amount of future payments that could potentially result from any hypothetical future claim, but believe the risk of having to make any payments under this general indemnification to be remote.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

In comparison with what we disclosed in our Annual Report on Form 10-K for fiscal 2003, we believe that there have been no significant changes in our market risk exposures for the quarter ended March 5, 2004.

### **ITEM 4. CONTROLS AND PROCEDURES**

Based on their evaluation as of March 5, 2004, our Chief Executive Officer and Chief Financial Officer, have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) were sufficiently effective to ensure that the information required to be disclosed by us in this quarterly report on Form 10-Q was recorded, processed, summarized and reported within the time periods specified in the SEC's rules and Form 10-Q.

There were no changes in our internal controls over financial reporting during the quarter ended March 5, 2004 that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within Adobe have been detected.

## **PART II—OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

In early 2002, International Typeface Corporation (“ITC”) and Agfa Monotype Corporation (“AMT”), companies which have common ownership and management, each charged, by way of informal letters to Adobe, that Adobe’s distribution of font software, which generates ITC and AMT typefaces, breaches its contracts with ITC and AMT, respectively, pursuant to which Adobe licensed certain rights with respect to ITC and AMT typefaces. AMT and ITC further charged that Adobe violated the Digital Millennium Copyright Act (“DMCA”) with respect to, or induced or contributed to, the infringement of copyrights in, ITC’s and AMT’s TrueType font software.

On September 4, 2002, Adobe initiated arbitration proceedings in London, England (“the London Arbitration”) against AMT, seeking a declaration that Adobe’s distribution of font software that generates AMT typefaces did not breach its contract pursuant to which it licensed certain rights with respect to AMT typefaces. AMT has made a breach of contract claim in response to Adobe’s arbitration demand in the London Arbitration, asserting that Adobe wrongfully granted and/or allowed third parties greater rights to distribute and embed AMT fonts than Adobe was licensed to grant and/or allow.

Adobe asserts that it negotiated for and obtained express, written licenses from both AMT and ITC approximately ten years ago permitting Adobe to allow end users to embed AMT and ITC fonts in electronic documents for “print and view” and disputes the other breach of contract claims. Adobe also asserts that Adobe Acrobat 5.0, which AMT and ITC correctly acknowledge has been superseded by subsequent versions, neither violates the DMCA nor induces or contributes to the infringement of copyrights in ITC’s and AMT’s TrueType font software.

On September 5, 2002, AMT and ITC filed suit against Adobe in the U.S. District Court, Eastern District of Illinois (“the Illinois Action”), asserting only that Adobe’s distribution of the superseded 5.0 version of Adobe Acrobat violated the DMCA, as described above. The Illinois Action seeks statutory damages of \$200 to \$2,500 for each copy of Acrobat 5.0 found to violate the DMCA, a claim that Adobe disputes as a matter of law and fact. The Illinois Action also seeks injunctive relief with respect to Acrobat 5.0, although it specifically alleges, correctly, that Adobe no longer distributes Acrobat 5.0.

On November 13, 2002, ITC filed another suit against Adobe in the United States District Court for the Eastern District of Illinois, this time asserting that Adobe breached its contract with ITC and that ITC, not Adobe, owns the copyrights in font software created by Adobe which generates ITC typefaces.

If either AMT or ITC prevails on its breach of contract claims, AMT or ITC may have the right to terminate Adobe’s right to distribute any of its products that then still contain font software that generates AMT or ITC typefaces.

The results of any litigation are inherently uncertain and Adobe cannot assure that it will be able to successfully defend itself against any of the actions described above. AMT and ITC seek an unspecified aggregate dollar amount of damages. A favorable outcome for AMT or ITC in these actions could have a material adverse effect on Adobe’s financial position, cash flows or results of operations. We believe that all of AMT’s and ITC’s claims are without merit and we are vigorously defending against them in addition to pursuing our own claims as described above.

On September 6, 2002, Plaintiff Fred B. Dufresne filed suit against Adobe, Microsoft Corporation, Macromedia, Inc. and Trellox Corporation in the U.S. District Court, District of Massachusetts, alleging infringement of U.S. Patent No. 5,835,712, entitled “Client-Server System Using Embedded Hypertext Tags for Application and Database Development.” The Plaintiff’s complaint asserts that “Defendants have infringed, and continue to infringe, one or more claims of the ‘712 patent by making, using, selling and/or offering for sale, *inter alia*, products supporting Microsoft Active Server Pages technology.” The plaintiff seeks unspecified compensatory damages, preliminary and permanent injunctive relief, trebling of damages



for “willful infringement,” and fees and costs. We believe the action has no merit and are vigorously defending against it.

On November 18, 2002, Plaintiffs Shell & Slate Software Corporation and Ben Weiss filed a civil action in the U.S. District Court in Los Angeles against Adobe alleging false designation of origin, trade secret misappropriation, breach of contract and other causes of action. The claim derives from the Plaintiffs’ belief that the “healing brush” technique of Adobe Photoshop software incorporates the Plaintiffs’ trade secrets. The Plaintiffs seek preliminary and permanent injunctive relief, compensatory, treble and punitive damages and fees and costs. We believe the action has no merit and are vigorously defending against it. On September 9, 2003, Adobe filed a counter-claim against Ben Weiss for breach of contract and misappropriation of trade secrets. Adobe seeks compensatory, statutory and punitive damages.

From time to time, in addition to those identified above, Adobe is subject to legal proceedings, claims, investigations and proceedings in the ordinary course of business, including claims of alleged infringement of third-party patents and other intellectual property rights, commercial, employment and other matters. In accordance with generally accepted accounting principles, Adobe makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. Litigation is inherently unpredictable. However, Adobe believes that it has valid defenses with respect to the legal matters pending against it. It is possible, nevertheless, that our financial position, cash flows or results of operations could be affected in any particular period by the resolution of one or more of these contingencies.

## ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

(e) Below is a summary of stock repurchases for the quarter ended March 5, 2004 (in thousands, except average price per share). See Note 6 of our Notes to Condensed Consolidated Financial Statements for information regarding our stock repurchase plans.

<u>Plan/Period</u>	<u>Shares Repurchased(1)</u>	<u>Average Price Per Share</u>	<u>Maximum Number of Shares that May Yet Be Purchased Under the Plan</u>
<b><i>Stock Repurchase Program I</i></b>			
Beginning shares available to be issued . . . . .			23,526,113
November 29, 2003 - January 2, 2004			
From employees(2) . . . . .	1,102	\$40.38	
Open market . . . . .	489,500	39.20	
January 3, 2004 - January 30, 2004			
From employees(2) . . . . .	1,328	37.94	
Open market . . . . .	577,000	38.26	
January 31, 2004 - March 5, 2004			
From employees(2) . . . . .	1,456	37.95	
Open market . . . . .	365,000	39.06	
Adjustments to repurchase authority for net dilution . . . . .			(148,883)(3)
Total shares repurchased . . . . .	<u>1,435,386</u>		<u>(1,435,386)</u>
Ending shares available to be issued . . . . .			<u>21,941,844(4)</u>

(1) All shares were purchased as part of publicly announced plans.

(2) The repurchases from employees represent shares canceled when surrendered in lieu of cash payments for the option exercise price or withholding taxes due.

(3) Adjustment of authority to reflect underwater options which are no longer dilutive.

(4) The remaining authorization for the ongoing stock repurchase plan is determined by combining all stock issuances, net of any canceled, surrendered or exchanged shares less all stock repurchases under the ongoing plan, beginning in the first quarter of fiscal 1998.

## ITEM 5. OTHER INFORMATION

Consistent with Section 10A(i)(2) of the Securities Exchange Act of 1934 as added by Section 202 of the Sarbanes-Oxley Act of 2002, we are responsible for listing the non-audit services approved in the first quarter of 2004 by our Audit Committee to be performed by KPMG LLP, our external auditor. Each of the permitted non-audit services has been pre-approved by the Audit Committee or the Audit Committee's Chairman pursuant to delegated authority by the Audit Committee. During the first quarter of 2004, the Audit Committee pre-approved the following non-audit services anticipated to be performed by KPMG LLP: 1) fiscal 2003 statutory audits and 2) fiscal 2003 tax return services.

## ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

### (a) Index to Exhibits

Exhibit Number	Exhibit Description	Incorporated by Reference			Filed Herewith
		Form	Date	Number	
3.2	Amended and Restated Bylaws as currently in effect	10-K	02/26/03	3.2	
3.4	Agreement and Plan of Merger effective 5/30/97 (by virtue of a reincorporation), by and between Adobe Systems Incorporated, a California corporation and Adobe Systems (Delaware) Incorporated, a Delaware corporation	10-Q	05/30/97	2.1	
3.6	Restated Certificate of Incorporation, as filed with the Secretary of State of the State of Delaware on 5/22/01	10-Q	7/16/01	3.6	
4.2	Fourth Amended and Restated Rights Agreement between the Company and Computershare Investor Services, LLC	8-K	7/3/00	1	
10.1.6	1984 Stock Option Plan, as amended*	10-Q	07/02/93	10.1.6	
10.21.3	Revised Bonus Plan*	10-Q	02/28/97	10.21.3	
10.23	Amended 1994 Performance and Restricted Stock Plan*	10-Q	05/29/98	10.24.2	
10.24	1994 Stock Option Plan*	10-Q	5/27/94	10.1.7	
10.25	1994 Stock Option Plan, as amended*	S-8	05/30/97	10.40	
10.26	1997 Employee Stock Purchase Plan, as amended*	10-K	12/1/00	10.70	
10.28	1996 Outside Directors Stock Option Plan*	10-Q	05/31/96	10.36	
10.29	1996 Outside Directors' Stock Option Plan, as amended*	S-8	6/16/00	4.7	
10.30	Forms of Stock Option Agreements used in connection with the 1996 Outside Directors' Stock Option Plan*	S-8	6/16/00	4.8	
10.31	1996 Outside Directors Stock Option Plan, as amended*	10-Q	7/16/01	10.75	
10.32	1996 Outside Directors' Stock Option Plan, as amended*	S-8	6/14/02	4.6	
10.33	1996 Outside Directors' Stock Option Plan, as amended*	10-K	2/5/04	10.33	
10.34	1999 Nonstatutory Stock Option Plan*	S-8	9/15/99	4.6	
10.35	1999 Nonstatutory Stock Option Plan, as amended*	S-8	12/22/00	4.6	
10.36	1999 Nonstatutory Stock Option Plan, as amended*	S-8	3/15/01	4.7	
10.37	1999 Nonstatutory Stock Option Plan, as amended*	S-8	10/29/01	4.6	
10.38	1999 Equity Incentive Plan, as amended*	10-K	02/26/03	10.37	
10.39	2003 Equity Incentive Plan	DEF 14A	3/17/03	10.1	
10.41	Form of Indemnity Agreement*	10-Q	05/30/97	10.25.1	

Exhibit Number	Exhibit Description	Incorporated by Reference			Filed Herewith
		Form	Date	Number	
10.42	Amended and Restated Limited Partnership Agreement of Adobe Incentive Partners, L.P.*	10-Q	8/28/98	10.42	
10.43	Amendment to Limited Partnership Agreement of Adobe Incentive Partners, L.P.*	10-Q	6/4/99	10.52	
10.44	Adobe Incentive Partners, L.P. Consent to Dissolve and Terminate Partnership*	10-K	02/26/03	10.44	
10.45	Forms of Retention Agreement*	10-K	11/28/97	10.44	
10.53	Amended, Restated and Consolidated Master Lease of Land and Improvements by and between Sumitomo Bank Leasing and Finance, Inc. and Adobe Systems Incorporated	10-Q	9/3/99	10.53	
10.54	Credit Agreement among Adobe Systems Incorporated, Lenders named therein and ABN AMRO Bank N.V., as Administrative Agent, with certain related Credit Documents	10-Q	9/3/99	10.54	
10.56	Note Secured by Deed of Trust and Promissory Note*	10-K	12/3/99	10.56	
10.66	Credit Agreement among Adobe Systems Incorporated, Lenders Named therein and ABN Amro Bank N.V., as Administrative Agent, with Certain Related Credit Documents	10-Q	9/1/00	10.66	
10.67	Amendment No. 1 to 1999 Credit Agreement among Adobe Systems Incorporated, Lenders Named Therein and ABN Amro Bank N.V., as Administrative Agent, with Certain Related Credit Documents	10-Q	9/1/00	10.67	
10.68	Amendment No. 1 to Amended, Restated and Consolidated Master Lease of Land and Improvements between Adobe Systems Incorporated and Sumitomo Bank Leasing and Finance, Inc.	10-Q	7/16/01	10.68	
10.69	Amendment No. 2 to Amended, Restated, and Consolidated Master Lease of Land and Improvements between Adobe Systems Incorporated and Sumitomo Bank Leasing and Finance, Inc.	10-Q	9/1/00	10.68	
10.77	Lease agreement between Adobe Systems and Selco Service Corporation	10-K	2/21/02	10.77	
10.78	Participation agreement among Adobe Systems, Selco Service Corporation, et al.	10-K	2/21/02	10.78	
10.79	Confidential Resignation Agreement*	10-K	2/21/02	10.79	
10.80	Executive Severance Plan in the Event of a Change of Control*	10-K	2/21/02	10.80	
10.81	Amendment No.1 to Lease Agreement between Adobe and Selco Services Corporation	10-K	02/26/03	10.81	
31.1	Certification of Chief Executive Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934				X

Exhibit Number	Exhibit Description	Incorporated by Reference			Filed Herewith
		Form	Date	Number	
31.2	Certification of Chief Financial Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934				X
32.1	Certification of Chief Executive Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934				X
32.2	Certification of Chief Financial Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934				X

\* Compensatory plan or arrangement

(b) Reports on Form 8-K

- (i) On December 11, 2003, Adobe filed a report on Form 8-K under Item 12 announcing its financial results for the quarter and fiscal year ended November 28, 2003.

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ADOBE SYSTEMS INCORPORATED

By /s/ MURRAY J. DEMO

Murray J. Demo,  
Senior Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)

Date: April 7, 2004

### **SUMMARY OF TRADEMARKS**

The following trademarks of Adobe Systems Incorporated, which may be registered in certain jurisdictions, are referenced in this Form 10-Q:

Adobe  
Acrobat  
GoLive  
Photoshop  
PostScript

All other brand or product names are trademarks or registered trademarks of their respective holders.